



# “ On T h e M o n e y R e p o r t ”

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## When to Buy Junk Bonds

**A well-diversified portfolio can profit from an allocation to junk—if you know when to invest.**

With yields approaching 40 year lows, investors' search for higher yielding investments will inevitably draw them to the junk bond market. Of course, everyone knows, the higher the yield, the greater the risk, but most people don't know how to quantify that risk in order to take the appropriate action at the appropriate time.

First, some definitions.

Junk bonds (also called High Yield Bonds) are bonds with ratings below BBB. The top four ratings available to bonds are: AAA ,AA ,A, and BBB. Anything below this rating is considered to be a "junk" bond. Lower quality bonds mean the companies which issue them have a reduced ability to pay interest and principal back to the investor.

In today's junk-bond market, according to the Wall Street Journal, the Merrill Lynch High Yield Master Index has a yield of 12.68%. This is very high, especially considering that treasury bonds with comparable maturities (10 years) have a yield of only 3.90%.

This means that there is an extra 8.78% paid to you to take on the extra risk of buying lower quality bonds.

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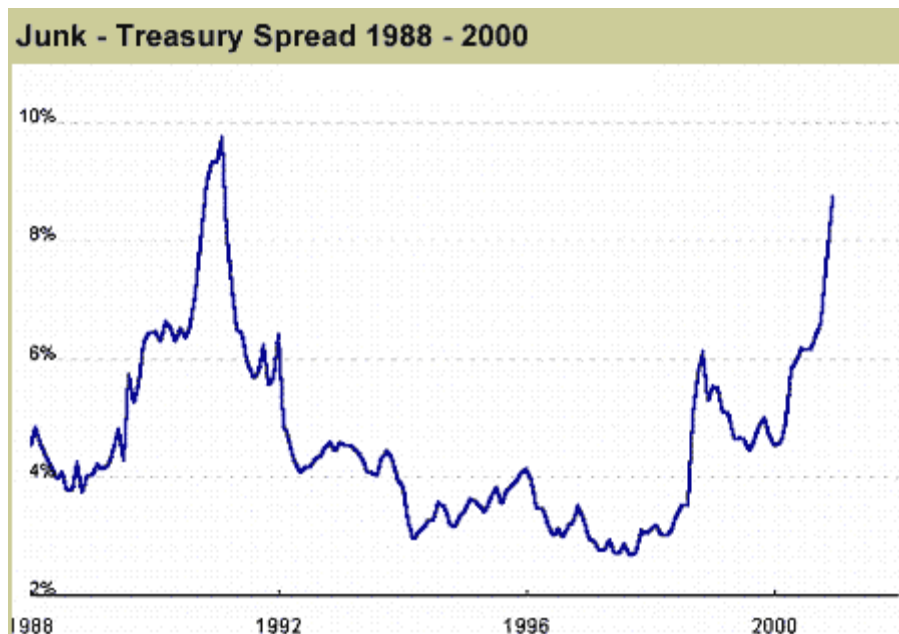


# “On The Money Report”

The question then becomes, exactly what risk am I taking in order to get this extra return? Said another way; if companies default (cease to pay interest) in my junk bond portfolio, how much of that extra 9% will I lose?

The answer can only be determined by looking at the past history of bond defaults and comparing these numbers to the excess amount you would get from current ownership of these low-rated bonds.

Now, let's take a look at the spread between junk bonds and treasury bonds over the past 13 years. (from *Grant's Interest Rate Observer*)



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The spread depicted in the above graph corresponds roughly to B-rated debt. Please note the very wide range of spreads, from around 3% (1994-1997) to almost 10% (1991).

## Calculating the risk

To understand the risk, you'll need to know the default rate. This obviously, refers to the proportion of companies defaulting per year.

It's important to note that not all companies that default go bankrupt. About 40% of defaulting companies do not go bankrupt. So a portfolio's actual reduction in return is the difference between the rate of default and the rate of recovery. In this discussion the number would be 60% (1-.40).

So, if the default rate is 4% and the recovery rate is 40%, then the portfolio's total return has been reduced by 2.4%. (4% less 60%=2.4%)

According to Moody's, the annual long-term default rate for BB bonds is about 1.5%; and for B, about 7%. But in any given year, the default rate varies widely. Based on recent market trends, the period from 1988 to 1997 yields some useful insights.

The BB-rated bonds seem to default at about 2% per year, on average, and the B-rated bonds at about 4% per year. Of course, rates can temporarily be much higher—even 8% to 10% per year at times for B-rated debt. But remember, default does not mean total loss; about 40% of defaulted debt is eventually recovered.



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So estimate a 1.2% annual long-term loss rate for BB-rated, and about 2.5% annual for B-rated.

## Calculating the return

We now have the tools to rationally investigate high-yield investing.

- 1 The risk premium of junk is simply the Junk to Treasury Spread minus the loss rate. (Today, the junk to treasury spread is about 9%). Is it rational to invest in a portfolio of B-rated high-yield securities that offers a 3% yield premium over Treasuries? Only an unsophisticated or foolish person would do so. With an annual default rate of roughly 7% and a recovery rate of 40%, we're losing about 4.2% of return per year. We would end up with lower return than investing in risk-free treasuries.
- 2 Historically, the spread is about 4.5%, but if we are only getting a 3% spread, even this does not provide an adequate return premium. The reason? The excess return would be a paltry .3%! Hardly worth the extra risk. Today, however, since the spread is about 9%, things look different. Running the same calculation, we subtract from 9% a loss rate of 7% times .6 and get a risk premium of 4.8%. More than enough room for the unexpected and plenty of excess return.
- 3 Junk bonds are different from stocks in one substantial aspect: while a stock or stock index can remain cheaply valued for decades, *a distressed bond that does not default will pay back principal and interest at maturity*. In the long term, in other words, the only way of being burned with a properly diversified high-yield portfolio is if the future average default rate is much higher than in the past. And



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- remember, the recent past includes the 1989–91 debacle—the worst in high-yield history.
- 4 Finally, there is a pretty clear-cut relationship between today’s spread and future returns. The higher the spread, the greater the advantage of bearing the extra credit-risk (of course, past performance is no guarantee of future results).

## The Bottom Line

If you are willing to take a reasonable risk for the possibility of reasonable gain, junk bonds, at today’s rates, may be worth a look.

*Steve*

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“The Investor’s Advocate”  
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Supplemental information from *William J. Bernstein*

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